STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Original Bill

Author: Assembly Revenue & Taxation Committee

Sponsor: The three-member Franchise Tax Board

Related Bills: See Legislative History

Bill Number: AB 1582

Introduced: March 10, 2021

SUBJECT

Real Estate Withholding/ Internal Revenue Code (IRC) section 1031 Deferred Like-kind Exchange/Failure to Withhold by Qualified Intermediaries (QI)/ Cash-Poor Exchange Taxpayers' Bill Of Rights Annual Report to the Legislature/Change Due Date

SUMMARY

This bill, under the Revenue and Taxation Code (RTC), would do the following:

Provision No.1: This provision would limit a QIs withholding obligation to available funds in those situations where the QI does not receive sufficient funds from escrow or the QI disbursed funds for the purpose of completing an exchange under IRC section 1031.

Provision No.2: This provision would change the Taxpayers' Bill of Rights Annual Report statutory due date from December 1st to January 15th.

RECOMMENDATION

Support. On December 18, 2020, the three-member Franchise Tax Board voted to sponsor this legislation.

REASON FOR THE BILL

The reason for this bill is to reduce the compliance burden on QIs while retaining the department's overall withholding structure, and to extend the statutory due date of the Taxpayers' Bill of Rights Annual Report.

ANALYSIS

Analysis Provision 1:

This provision, under the RTC, would amend the real estate withholding provisions by limiting a QI's withholding obligation to available funds in those situations where the QI does not receive sufficient funds from escrow or the QI disbursed funds for the purpose of completing an exchange under IRC section 1031.

The Franchise Tax Board (FTB) would be authorized to prescribe regulations to implement this change clarifying when a disbursement is for the purpose of completing an IRC section 1031 exchange.

This bill would exempt the FTB's, rules, guidelines, procedures, or other guidance related to this provision from the requirements of the Administrative Procedure Act.

Effective/Operative Date

This provision would be effective January 1, 2022, and would be operative for dispositions of California real property interests that occur on or after January 1, 2022.

Federal/State Law

Like-Kind Exchange/Deferred Exchange

Under federal law, IRC section 1031, generally allows the deferral of gain from the sale or disposition of property used in a trade or business or held for investment if replacement property of "like-kind" is acquired. There are specific requirements the taxpayer must meet to qualify for the gain deferral.

For federal purposes, exchanges completed in 2018 and after are not allowed for personal or intangible property.

If the taxpayer transfers property but will not receive other property in exchange until a later date, the transaction must comply with the following statutory time periods:

- The property to be received is identified within 45 days after the taxpayer transferred the property given up in the exchange.
- The identified property is received by the earlier of:
    - The 180th day after the date on which the taxpayer transferred the property given up in the exchange.
    - The due date, including extension, of the taxpayer's tax return for the year in which the taxpayer transferred the property given up.

To be treated as a deferred exchange, a transaction must be an exchange of property for property, not a transfer of property for money, even if the taxpayer buys replacement property of a like-kind at a later date. Thus, a sale of property followed by a purchase of property that is of a like-kind to the property sold does not qualify for no recognition of gain or loss even if the other requirements for a like-kind exchange are met.

Additionally, a partially taxable exchange occurs when the taxpayer receives money or unlike property in addition to like-kind property in the exchange on which the taxpayer realizes a gain. The taxpayer recognizes the gain to the extent of the money and of the fair market value (FMV) of the unlike property.

For state purposes, for exchanges completed after January 10, 2019, California conforms to federal law with modifications. California conforms to the federal limitation that prohibits exchanges of personal or intangible property.

For individuals, this limitation only applies if either:

- An individual who is a head of household, a surviving spouse, or spouses filing a joint return with adjusted gross income (AGI) of $500,000 or more for the tax year in which the exchange begins, or
- For any other individual with AGI of $250,000 or more for the tax year in which the exchange begins.

However, the California change does not apply to the exchange if:

- The property disposed of by the taxpayer in the exchange is disposed of on or before January 10, 2019, or
- The property received by the taxpayer in the exchange is received on or before January 10, 2019.

California Information Return Filing Requirement for Like-Kind Exchange

Under state law, for taxable years beginning on or after January 1, 2014, taxpayers who defer gain or loss under IRC section 1031 when they exchange California real property for like-kind property located outside of California are required to file form FTB 3840 California Like-Kind Exchanges, with the FTB. This form must be filed in the year the exchange is completed and each subsequent year the deferred gain or loss from the exchange is not recognized.

The filing requirement applies to all individuals, estates, trusts, and all business entities regardless of their residency status or commercial domicile.

Real Estate Withholding in a Deferred Exchange

Federal law, the Foreign Investment in Property Tax Act (FIRTPA), provides for withholding on the disposition of U.S. real property interests by a foreign person. Persons purchasing U.S. real property interests (transferees) from foreign persons, certain purchasers' agents, and settlement officers are generally required to withhold 15 percent of the amount realized on the disposition (special rules for foreign corporations). In most cases, the transferee/buyer is the withholding agent. For cases in which a U.S. business entity such as a corporation or partnership disposes of a U.S. real property interest, the business entity itself is the withholding agent.[1]

California does not conform to FIRTPA, and instead provides a "standalone" provision for real estate withholding. The QI must withhold when either of the following occur:

- The transferor receives "boot" in excess of $1,500, including cash, excess debt relief, or non-like-kind property from the sale. The QI must withhold 3 1/3 percent (.0333) of the boot. If an election is made to use the alternative withholding calculation method (completed on Form 593) then the QI must withhold the amount determined through the election.
- The exchange fails, does not occur, or does not meet the IRC section 1031 requirements, regardless of the transferor's certification that the transaction is a like-kind exchange, unless another exemption applies. If the exchange fails and no other exemptions applies, the QI must withhold 3 1/3 percent (.0333) of the sales price unless an election is made to use the alternative withholding calculation method.

Under current state law, the QI must remit the full withholding amount even if the QI does not receive sufficient funds from escrow. Otherwise, the QI may be subject to a penalty for failure to remit the full amount of withholding, discussed below.

Penalty for Failure to Withhold

State law generally provides, unless it is shown that the failure to withhold is due to reasonable cause, the transferee, including a QI, is liable for the greater of the following amounts for failure to withhold:

- Five hundred dollars ($500).
- Ten percent of the amount required to be withheld.

[1] See IRS website, FIRTPA Withholding (https://www.irs.gov/individuals/international-taxpayers/firpta-withholding)

Reasonable cause is a standard exception to many penalties under the RTC and the IRC. Generally, reasonable cause exists where noncompliance occurs despite the exercise of ordinary business care and prudence.

If a QI does not receive sufficient funds from escrow to pay the withholding (cash-poor exchange), the withholding penalty may be abated based on reasonable cause. A strong factor to support a reasonable cause determination would be if the QI provides evidence that the QI submitted a written demand to the transferor at the time the withholding is due to require the transferor to remit the amount of any shortage. If it is shown that noncompliance was due to reasonable cause and was not due to willful neglect based on the facts, FTB will abate the penalty.

Implementation Considerations

Implementing this provision would not significantly impact the department's programs or operations.

Technical Considerations

None noted.

Policy Considerations

This proposal would reduce the burden of compliance on QIs in situations where QIs lack sufficient funds to satisfy the full withholding obligation. This proposal would encourage compliance by promoting a fair and equitable tax system while retaining the overall withholding structure.

LEGISLATIVE HISTORY

AB 3078 (Assembly Revenue and Taxation Committee, Chapter 305, Statutes of 2008), sponsored by the three-member Franchise Tax Board, among other changes, amended the real estate withholding provisions for nonresident individuals and non-California businesses.

PROGRAM BACKGROUND

California law and regulations require withholding on sales or transfers of California real property when the total sales price exceeds $100,000 and the transaction or seller does not qualify for an exemption. Real estate withholding is a prepayment of income (or franchise) tax due from sellers on the gain from the sale of California real property, and does not relieve sellers from the requirement to file a tax return. Even if the seller is exempt from real estate withholding requirements, they may still owe California taxes and have a requirement to file a California tax return.

A deferred exchange, also referred to as a non-simultaneous or delayed like-kind exchange, occurs when a taxpayer transfers property, and after the transfer, receives like-kind property. The QI will submit the Form 593 Real Estate Withholding Statement in a deferred exchange.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact is unknown, although it is anticipated there could be a minor revenue loss attributable to the failure to withhold penalty that would no longer be imposed in those situations where a QI is relieved of their requirement to withhold.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this proposal.

Revenue Discussion

Under this proposal, QIs with insufficient funds in a deferred exchange transaction, would be relieved of their requirement to withhold to the extent of funds being unavailable. It is difficult to predict the frequency, timing, and the value of these transactions.

Historically, a penalty for failure to withhold in a deferred exchange transaction has been primarily used as a deterrent for non-compliance. If the QI had a hardship complying with the withholding requirement because the QI received insufficient funds from escrow to pay the withholding, FTB may abate the penalty based on reasonable cause.

This proposal would still require the QI to file Form 593 and report withholding for "boot" and failed exchanges absent the exchange being "cash-poor," which would limit withholding to available funds. Additionally, the Form 593 would require the QI to provide identifying information on the seller and attest that the transaction was a "cash-poor" exchange.

This proposal would not relieve the seller of their responsibility to report and pay the tax liability on their return. As the FTB would still be receiving data that would flow to the tax return, it is presumed that there would be continued compliance with reporting requirements. However, since withholding is a prepayment of potential tax liability, we anticipate a slight change in the timing and payment of this liability, but do not expect this to be a measurable change. Actual amount of tax liabilities would not be affected.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

Support: The three-member Franchise Tax Board.

Opposition: None noted.

ARGUMENTS

To be determined.

Analysis Provision 2:

This provision, under the RTC, would change the Taxpayers' Bill of Rights Annual Report statutory due date from December 1st to January 15th.

However, the 2021 report would still be due by December 1st.

Effective/Operative Date

This provision would be effective and operative beginning January 1, 2022.

Federal/State Law

Federal Law

No provision comparable to federal law.

State Law

The FTB is required to provide an annual Taxpayers' Bill of Rights Report to the Legislature no later than December 1st. The report is required to include recommendations for improving taxpayer compliance and uniform administration, including changes in statutes.

Implementation Considerations

Implementing this provision would not significantly impact the department's programs or operations.

Technical Considerations

None noted.

Policy Considerations

In moving the report due date to January 15th of each year, this would allow departmental staff sufficient time to include in the report current legislative proposals (LPs) that otherwise would not be included until the following year's report.

LEGISLATIVE HISTORY

AB 3078 (Assembly Revenue and Taxation Committee, Chapter 305, Statutes of 2008), among other changes, modified the information required to be included in the Taxpayers' Bill of Rights Annual Report to the Legislature.

AB 1741 (Assembly Revenue and Taxation Committee, Chapter 341, Statutes of 2007) changed the Taxpayers' Bill of Rights Annual Report statutory due date from October 1st to December 1st.

PROGRAM BACKGROUND

Taxpayers' Bill of Rights Report

By December 1st of each year, the FTB is required to submit to the Legislature an annual report that includes the following:

- Identifies recurrent areas where taxpayers are not complying with the tax law.
- Shows the volume of assessments for both personal income taxes and franchise bank and corporation taxes taken from sample data from the audit process.
- Identified reporting errors that were detected during the initial processing of the previous year's tax returns.

- Includes strategies to improve taxpayer compliance through changes in the law, improved training of staff, enhanced communications with taxpayers and tax practitioners, and increased enforcement capabilities.

It is specifically the last item to which this provision relates (i.e. strategies to improve taxpayer compliance through law changes) and our ability to include the most up to date information regarding FTB's LPs in the report.

Departmental Legislative Proposals

Each year, FTB identifies LPs that can ease tax administration, including possible ways to improve compliance. These LPs are typically presented for approval at the December three-member Franchise Tax Board meeting. The most recent meeting was held on Friday, December 18, 2020. Below are the last six years of meeting dates.

Prior year's board meetings:

LPs Presented	Board Meeting Date
2021 LPs	December 18, 2020
2020 LPs	December 3, 2019
2019 LPs	December 18, 2018
2018 LPs	December 7, 2017
2017 LPs	December 8, 2016
2016 LPs	December 15, 2015

Once an LP is approved by the three-member Franchise Tax Board, FTB staff will seek authors to carry the proposals through the legislative process.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would not impact revenue.

LEGAL IMPACT

None noted.

APPOINTMENTS

None Noted.

SUPPORT/OPPOSITION

Support: The three-member Franchise Tax Board.

Opposition: None noted.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

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